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### **AGENDA ITEM 3a**

#### **TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE**

- I. SUBJECT:** Revision of Credit Enhancement Program
- II. PROGRAM:** Credit Enhancement Program
- III. RECOMMENDATION:** Approve the reading and recommend to the Investment Committee approval of the Credit Enhancement Policy revisions
- IV. ANALYSIS:**

#### *Executive Summary:*

The Credit Enhancement Program (CEP) Policy was adopted on February 14<sup>th</sup>, 2005 by the Investment Committee. After over a year of operation, Staff is proposing to revise the CEP Policy in order to improve operational flexibility while maintaining the Program's risk profile.

#### *Summary of Proposed Policy Revisions:*

- Remove the Originator and Servicer requirements from the Policy and all associated references (Please see Attachment 1, pages 2-5)
- Add a Program Partnership requirement to the Credit Approval Policy and Procedures section (Please see Attachment 1, page 6)
- Update the Fixed Income Credit Enhancement Program glossary (Please see Attachment 2).

The Originator and Servicer requirements were originally intended to provide an operational framework for the program which relied on a single originator and servicer (Bank of NY). The original policy included fiduciary language which provided an added layer of support during the early phase of the program. As the Program has evolved, the language set forth in the Originator and Servicer requirements (Fiduciary, rating criteria and reporting requirements) has constrained staff's ability to use multiple deal

sources and partner with other financial institutions. This has resulted in less deal flow and a higher cost structure. Staff is proposing the removal of the Originator and Servicer Requirements which will improve staff's ability to grow the Program while maintaining its risk profile. Wilshire has reviewed the proposed changes and concurs with staff (See Attachment 3). Justifications for the removal of Originator and Servicer requirements are listed below:

1. Improve Business Processes

- a. The Policy as revised is consistent with other Fixed Income Policies that focus on risk control instead of operational or business implementation.
- b. The removal of the Originator and Servicer requirements will increase deal flow, allow for the creation of a consortium, which will result in higher fee income and eliminate the dependency on a sole originator.
- c. Originator and Servicer agreements will be defined and negotiated in contracts and incorporated into the CEP procedure manual. This creates flexibility for the Program to adapt to the changing market conditions.
- d. The proposed changes are consistent with existing market practices which utilize multiple partners to source transactions.
- e. The elimination of the Originator and Servicer requirements allows for increased operational flexibility which allows for multiple party outsourcing and the potential to service transactions internally.

2. Risk Control

- a. CalPERS AAA CEP rating is based on the financial strength of the organization, the Program's conservative underwriting guidelines, as well as CalPERS disciplined internal credit review process.
- b. The current underwriting guidelines were established in concert with the Rating Agencies.
- c. The Rating Agencies are not concerned with the removal of the Originator and Servicer requirements from the CEP Policy (Please refer to Attachment 4).

- d. The Rating agencies expect Staff to perform independent due diligence for each transaction.
- e. The credit commitments issued under the Program undergo a similar approval / due diligence process to that of CalPERS internally managed Corporate securities, despite the fact that municipal securities have a significantly lower risk profile.
- f. The CEP credit approval process requires a unanimous vote from the Fixed Income Credit Committee to approve each CEP transaction.

In addition to removal of Originator and Servicer requirements, staff is proposing the addition of a Partnership requirement under the "Credit Approval Policy and Procedures" section of the policy. The Partnership and co-investment language will ensure that the CalPERS' interests are aligned with other financial partner / partners.

The CalPERS Investment Committee will be updated annually on any changes to the establishment and/or termination of partnerships, deal flows, and Program performance under the revised Policy.

**V. STRATEGIC PLAN:**

This item is consistent with the Strategic Plan, Goal VIII. to manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

**VI. RESULTS/COSTS:**

The Statement of Policy for the Credit Enhancement Program is presented to the Policy Subcommittee for approval. This Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns with the management and oversight of the Program.

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